VZCZCXRO6094
RR RUEHAG RUEHAST RUEHDA RUEHDBU RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA
RUEHLN RUEHLZ RUEHROV RUEHSR RUEHVK RUEHYG
DE RUEHTL #0092/01 0441357
ZNR UUUUU ZZH
R 131357Z FEB 07
FM AMEMBASSY TALLINN
TO RUEHC/SECSTATE WASHDC 9512
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE

UNCLAS SECTION 01 OF 02 TALLINN 000092

SIPDIS

STATE FOR EEB/CBA, EUR/NB

SIPDIS
SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN PGOV EN

SUBJECT: ESTONIA'S ECONOMY: OUTLOOK FOR CONTINUED GROWTH
LOOKS GOOD

REF: (A) 06 TALLINN 989 (B) TALLINN 33

¶1. (U) Estonia's economic growth has exceeded 10% for two years running. This has led to the inevitable question: "How long can it last"? Regional banks, the Ministry of Finance, and financial media all forecast around 9% real GDP growth in 2007, down from 11.5% in 2006. While a few local observers fear a sharper downturn in the coming months, the vast majority of analysts see the economy continuing to grow in the 7-9% range for the next several years. Some officials, including Prime Minister Andrus Ansip, have continued to express concern about the possibility of the economy overheating.

STRONG FUNDAMENTALS...

¶2. (SBU) Financial sector experts emphasize that Estonia's economic fundamentals are strong. Unlike Latvia and Lithuania, the GOE's budget has been running at a surplus (between 2-6%) since 2001. Moreover, Estonia's membership in the EU, sound fiscal and banking policies, oil-shale based energy independence, well-developed communications infrastructure, and its educated, multi-lingual workforce provide a strong basis for long-term economic growth. Rasmus Pikkani, Sampo Bank Chief Investment Officer and Aivar Reinap, the Chief Editor of Postimees Online both told us they expect the Estonian economy to continue growing at least 7-8% in the coming years, barring any major external shock. They noted that while 7-8% growth is lower than Estonia has experienced recently, it is still very respectable compared to the EU average. A recent Postimees article, which surveyed four commercial banks, the Estonian Institute of Economic Research, the Central Bank and the Finance Ministry, reported strong consensus among experts that Estonia will experience healthy economic growth in 2007. Growth predictions were remarkably similar, ranging from 8 to 9.5%. Both President Ilves and PM Ansip have told us they hope to see a mild cooling of the economy, as they believe that recent growth rates are not sustainable.

¶3. (SBU) Pikkani and Reinap told us they believe Estonia's economy is less vulnerable to external shocks than it was 4-6 years ago. Estimates are that the share of Estonia's economy that is dependent on Russia has fallen from 40% at the time of the 1998 ruble crisis, to roughly 10% today. Even if the GOR took steps to restrict trade, or the Russian economy took another sharp downturn, the impact on Estonia would be relatively limited, they said. Estonia is now firmly integrated into the EU market and its border with Russia is part of the EU's eastern border. Also, since the 1990s, Estonian exporters have successfully

developed mechanisms and relationships for exporting through neighboring countries to get around unexpected customs and trade barriers. Pikkani also said he does not believe a downturn in other EU economies would negatively impact Estonia. Rather, it could have the effect of making Estonia relatively more attractive as a lower-cost, near-shoring locale for companies in the old EU-15.

...AND AREAS TO WATCH

¶4. (SBU) While most analysts are predicting a soft-landing for the economy, this does not mean that there are no potential dangers on the horizon. Erki Lohmuste, Head of Macro Analysis at the Ministry of Finance, pointed to two factors that are generally believed to have the potential to cause problems for Estonia's economy in the next few years: an inflationary push caused by across-the-board demands for increased wages, and excess levels of credit and consumer debt. The country's growing labor shortage (Ref B) and the need for structural transition in the economy toward higher value-added exports and services are also challenges the economy will have to face. In this last regard, both analysts and politicians have highlighted to us the need to pay more attention to education and new technology as means of increasing productivity.

¶5. (SBU) As Lohmuste explained, the threat of a credit bubble is particularly hard to address because most of the lending comes from large Swedish and Finnish banks. They control over 95% of the market, but see their operations in Estonia as a relatively small part of their overall portfolios. This makes them more willing to make somewhat riskier loans. Nevertheless, Estonian Central Bank Governor Andres Lipstock told us recently that he has had

some success persuading Swedish Central Bank officials to caution the Swedish commercial banks that have branches in the Baltics to exercise greater due diligence over their loan portfolios.

¶6. (SBU) With respect to inflation, (which has averaged about 4% since 2002) the GOE is primarily concerned about meeting Maastrict targets for Euro zone entry. (Note: The GOE's informal target for this has slipped to 2011. End Note.) Sampo Bank's Pikkani expressed his concern that inflation's distortionary effects on consumer prices and public sector finances could have an impact on long term growth. As an example, he noted the fact that medical workers recently negotiated a 20% pay increase. If this increase is repeated in other public sectors, he asserted, it will add significantly to inflationary pressure on the economy. As GOE officials freely admit, they have few policy tools available to them to address inflation, and they have steadfastly refused to take any steps that might result in slower growth in order to rein in inflation. Estonia's currency has been pegged to the Euro since 1999, and to the Deutschmark for seven years before that. Pikkani and Reinap both feel that since Estonia has few if any monetary tools with which to control inflation, it is most important for the GOE to maintain its international reputation for transparency and fiscal responsibility.

GOLDSTEIN